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No. 96-454

In the Supreme Court of the United States

OCTOBER TERM, 1996

ASSOCIATES COMMERCIAL CORPORATION, PETITIONER

v.

ELRAY AND JEAN RASH

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether, when a debtor in a bankruptcy case is permitted to retain property that secures the claim of a secured creditor, the allowed amount of the secured claim is to be valued under Section 506(a) of the Bankruptcy Code at (i) the amount the creditor would realize from a hypothetical foreclosure sale of the property or (ii) the fair market value of the property in the hands of the debtor.

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INTEREST OF THE UNITED STATES

This case concerns whether, when a debtor is permitted to retain property that secures the claim of a secured creditor, the allowed amount of the secured claim is limited, under Section 506(a) of the Bankruptcy Code, to the amount that the creditor would have obtained in a hypothetical foreclosure sale. This issue is of substantial importance to the United States. The United States often becomes a secured creditor under federal programs involving loans, loan guarantees, contracts and tax collection activities. The rights of the United States as a secured creditor

are frequently affected by valuations of collateral under Section 506(a).

Because the decision in this case conflicts directly with decisions of the First, Second, Fourth, Sixth, Seventh, Eighth and Ninth Circuits, the United States and its agencies face disparate treatment in different circuits of identical claims arising under national programs. The United States therefore has a substantial interest in the resolution of this continuing conflict.

STATUTORY PROVISIONS INVOLVED

1. Section 506(a) of the Bankruptcy Code, 11 U.S.C. 506(a), provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

2. Section 1325 of the Bankruptcy Code, 11 U.S.C. 1325, provides in relevant part:

> (a) Except as provided in subsection (b), the court shall confirm a plan if—

* * * * *

> (5) with respect to each allowed secured claim provided for by the plan—
>
> (A) the holder of such claim has accepted the plan;
>
> (B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and
>
> (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or
>
> (C) the debtor surrenders the property securing such claim to such holder * * *.

STATEMENT

1. In 1992, respondents Elray and Jean Rash filed for relief under Chapter 13 of the Bankruptcy Code (Pet. App. 110a). Petitioner Associates Financial Commercial Corporation had provided purchase money financing to respondents and held a lien on a truck that respondent Elray Rash used in his business (*id.* at 111a). Over petitioner's objection, respondents proposed a plan under which (i) respondents would retain the truck for use in the continued operation of the business and (ii) the amount of petitioner's allowed secured claim would be reduced to the wholesale value of the truck (*id.* at 2a, 111a).[1]

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[1] The plan proposed by respondents is what is known as a "cramdown" plan, which is a plan that the debtor seeks to have confirmed over the objection of a secured creditor. When a

The bankruptcy court approved the plan and also approved respondents' valuation of petitioner's allowed secured claim. The court found that the truck had a wholesale value of $31,875 and a retail value of $42,500 (Pet. App. 111a). The court concluded that, under Section 506(a) of the Bankruptcy Code, the "allowed secured claim" should be valued at the wholesale value of the truck because "wholesale value most often equates to the value in the hands of the creditor after he has deducted his foreclosure and disposition costs so that it is a reasonable indication of the net proceeds he will receive upon the disposition of the reclaimed collateral" (*id.* at 113a). The district court affirmed the bankruptcy court's orders (*id.* at 83a-88a).

2. a. A panel of the court of appeals reversed (Pet. App. 100a-109a). The panel held that, under Section 506(a) of the Bankruptcy Code, the value of the allowed secured claim was the retail or replacement value of the truck in the hands of the debtor, not the wholesale value of the truck (Pet. App. 109a).

b. Respondent filed a petition for rehearing en banc. While that petition was pending, the First, Eighth, and Ninth Circuits issued decisions that agreed with the reasoning and conclusion of the panel

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debtor proposes a "cramdown" plan under which it will retain collateral that secures the claim of a secured creditor, the plan can be confirmed only if it provides payments to the secured creditor that equal or exceed the present value of the "allowed secured claim." 11 U.S.C. 1325(a)(5). The amount of the "allowed secured claim" is determined under Section 506(a) of the Bankruptcy Code, 11 U.S.C. 506(a). The portion of the secured claim that is not treated as an "allowed secured claim" under Section 506(a) is to be treated as an unsecured claim. *Ibid.*

decision in this case and with earlier decisions of the Sixth and Fourth Circuits on this same issue. *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72 (1st Cir. 1995); *In re Trimble*, 50 F.3d 530 (8th Cir. 1995); *In re Taffi*, 68 F.3d 306 (1995), aff'd in part on reh'g en banc, 96 F.3d 1190 (9th Cir. 1996), petition for cert. pending, No. 96-881; *In re McClurkin*, 31 F.3d 401 (6th Cir. 1994); *In re Balbus*, 933 F.2d 246 (4th Cir. 1991); *In re Coker*, 973 F.2d 258 (4th Cir. 1992).

In an en banc decision in which nine judges joined and six judges dissented, however, the Fifth Circuit rejected the panel decision and held that the value of the allowed secured claim must be limited to the wholesale value of the truck—the theoretical amount that the creditor would realize at a hypothetical foreclosure sale (Pet. App. 14a, 51a).

c. After the Fifth Circuit issued its *en banc* decision in this case, the Ninth Circuit issued an *en banc* opinion in *In re Taffi*, *supra*, expressly disagreeing with the Fifth Circuit and holding that, when the collateral is retained by the debtor, Section 506(a) requires that the secured claim be valued at the replacement, or fair market, value of the collateral. The Second and Seventh Circuits thereafter issued opinions in which they disagreed with all of the previous appellate decisions and concluded that, when the collateral is retained by the debtor, the "allowed secured claim" may be valued at the average of the wholesale and retail replacement values. *In re Valenti*, No. 95-5079, 1997 WL 31577 (2d Cir. Jan. 15, 1997); *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996).

SUMMARY OF ARGUMENT

1. The claim of a creditor who possesses a lien on any property of a bankruptcy estate is a "secured claim" under the Bankruptcy Code only "to the extent of the value of such creditor's interest in the estate's interest in such property" (11 U.S.C. 506(a)). The statute specifies that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property" (*ibid.*).

When, as in this case, "the proposed disposition or use" of the collateral to which the lien has attached is that it will be retained for the use of the debtor, the "value" of that property (and thus the amount of the "secured claim" under the statute) is the price that a willing buyer in the debtor's position would pay to obtain such property from a willing seller. Because, in this case, the debtor is a retail buyer of such property, the "value" of such property in the debtor's hands is the retail or replacement cost of such property to the debtor. That valuation of the property reflects the "economic benefit for the debtor" from its continued possession and "use of the collateral to generate an income stream" (*In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 75 (1st Cir. 1995)).

2. The court of appeals erred in this case in concluding that the "value" of the collateral (and therefore the amount of the "secured claim") equals the net proceeds that the creditor would have obtained if the property had been sold at a foreclosure sale. As all other appellate courts have concluded, if the "value" of the collateral is limited to the amount realizable from a hypothetical foreclosure sale even when a foreclosure is *not* to be conducted because the

collateral is instead to be retained and used by the debtor, "then the last sentence of the statute which provides that the value should be determined in light of the purpose of the valuation and the proposed disposition or use of the property would be surplusage" (*In re Trimble*, 50 F.3d 530, 532 (8th Cir. 1995)).

As these courts have explained, "[W]hen a debtor intends to continue use of creditor's collateral, the Debtors are acknowledging the value of the collateral to be greater than if liquidated" (*In re Trimble*, 50 F.3d at 531). The "debtor should not be heard to argue that, in valuing the collateral, the court should disregard the very event that, according to the debtor's plan, *will* take place—namely, the debtor's use of the collateral to generate an income stream." *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75. When property is to be retained by the debtor, its value in the hands of the debtor is thus "equal to [its] fair market value," not to its foreclosure value (*ibid.*).

3. In two recent decisions, the Second and Seventh Circuits have concluded that the value of collateral that will be retained and used by the debtor (and therefore the amount of the "secured claim" under Section 506(a)) is an amount halfway between (i) the retail price that a willing buyer in the debtor's position would actually be required to pay to obtain such property and (ii) the wholesale price for such property (even though that price would not be available to a buyer in the debtor's position). That "compromise" method for valuing collateral retained by the debtor lacks support either in logic or in the text of the statute.

Commercial property retained by the debtor has a readily discernible "value." That value is the cost that the debtor would incur in obtaining similar

property for the same use—the price that a willing buyer in the debtor's position would pay a willing seller for the right to obtain and use such property. The debtor in this case would be required to purchase such property at retail and would not be able to purchase such property at wholesale. The "value" of the property in the debtor's hands is thus necessarily its retail price—for that is the price the debtor would be required to pay for the right to use such property in its business.

ARGUMENT

WHEN THE DEBTOR IS PERMITTED TO RETAIN FOR HIS OWN USE THE COLLATERAL THAT SECURES A CREDITOR'S CLAIM, THE AMOUNT OF THE "ALLOWED SECURED CLAIM" IS THE FAIR MARKET VALUE, OR REPLACEMENT COST, OF THE PROPERTY IN THE HANDS OF THE DEBTOR

This case involves the proper valuation of a secured claim in a bankruptcy case when the debtor is permitted to retain and use the property that secures the claim. When, as in the present case, the debtor proposes to retain such property under a plan to which the secured creditor has objected, the court may approve the plan only if, among other requirements, it ensures that the holder of the secured claim will receive no less than the present value of the "allowed amount" of the "allowed secured claim." 11 U.S.C. 1325(a)(5)(B). See also 11 U.S.C. 1129(b)(2)(A)(i).

The "allowed amount of such claim" is determined under Section 506(a) of the Bankruptcy Code, 11 U.S.C. 506(a). The first sentence of Section 506(a) provides that an "allowed claim" that is secured by

property of the estate is "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property" and is an unsecured claim to the extent the claim exceeds that value. *Ibid.* The second sentence of Section 506(a) specifies that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property" (*ibid.*). The question in this case is how this "value" is to be determined when the "proposed disposition or use" of the property is that it will be retained by the debtor rather than sold at a foreclosure sale.

The court of appeals concluded in this case that, whether the property is to be sold at foreclosure or is instead to be retained for the use of the debtor, the "value" of the property in either situation is the same—the hypothetical net proceeds that would be realized *if* the property were sold at foreclosure. The court concluded that this hypothetical net foreclosure value is equal to the "wholesale" price of the property (Pet. App. 14a, 51a). As eight other courts of appeals have concluded, however, the analysis of Section 506(a) adopted by the court in this case is in error.

1. Under Section 506(a) of the Bankruptcy Code, the amount of the secured claim is defined by statute as the "value" of the "creditor's interest in the estate's interest" in the property. 11 U.S.C. 506(a). The court of appeals concluded that this sentence necessarily refers to the value that the creditor would receive if it foreclosed on the collateral—on the theory that the right of foreclosure represents the "creditor's interest" in the property (Pet. App. 14a). As all other courts of appeals have concluded, however, the "value" of the "creditor's interest" in the property is not limited to net foreclosure proceeds

when, as in the present case, the property is to be retained by the debtor and is *not* to be sold at foreclosure.

a. First, it is fundamentally incorrect to say that a creditor's interest in the property is to receive "only the net proceeds from the disposition of the collateral." *In re McClurkin*, 31 F.3d 401, 404 (6th Cir. 1994). "When a creditor forecloses * * * , the creditor 'receives' *all* of the proceeds of the sale." *Ibid.* When no costs are incurred in such a sale (as when a private sale is arranged), no reduction in the proceeds of the sale occurs. Section 506(a) "does not require or permit a reduction in the creditor's secured claim to account for purely hypothetical costs of sale" when such costs are, in fact, *not* incurred because the debtor has been permitted to *retain* the property and foreclosure has been enjoined by the bankruptcy court. *Id.* at 405. Accord, *e.g.*, *In re Taffi*, 96 F.3d at 1192 ("Hypothetical sale costs are not to be considered because no sale is intended."); *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 74 ("no deduction for hypothetical costs of sale" that are not, in fact, incurred).

Furthermore, as the court explained in *In re Green*, 151 B.R. 501, 505 (Bankr. D. Minn. 1993):

> the fact that a lien in property gives the lienholder a right to repossess and sell the collateral does not automatically mean that the value of the lien is equal to the amount that the creditor would receive upon disposition of the collateral in satisfaction of its lien. It must be remembered that a lien is fundamentally a *security* interest which secures payment of an obligation. To value such an interest in property based solely on the amount that could be realized upon sale of the collateral ignores the value associated with the right to receive the stream of payments that the lien secures.

The "value of the creditor's lien is derived from the stream of payments that the lien secures, rather than the right to foreclose," especially when, as in this case, "no liquidation of the collateral is contemplated" under the debtor's plan. *Id.* at 504.

b. Second, the text of the statute expressly requires that, in determining "value," consideration is to be given to the "purpose of the valuation" and to the "proposed disposition or use of such property" (11 U.S.C. 506(a)).[2] "[B]ecause the reorganizing debtor proposes to retain and use the collateral, it should *not* be valued as if it were being liquidated." *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 74. Instead, "courts should value the collateral 'in light of' the debtor's proposal to retain it and ascribe to it its going-concern or fair market value with no deduction for hypothetical costs of sale." *Ibid.*

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[2] "[T]he purpose of the valuation" refers to the procedural context in which the bankruptcy court is called upon to make a valuation. For example, this context may be the confirmation of a plan, the determination whether a secured creditor is adequately protected or the determination whether the debtor has exceeded the maximum amount of unsecured debts permitted for a Chapter 13 case. See, *e.g.*, *In re Balbus*, 933 F.2d 246 (4th Cir. 1991); David G. Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 Am. U.L. Rev. 63, 65-70 (1991). The "disposition" of the property may include the sale of property at foreclosure or its retention by the debtor. The "use" of the property may include the production of income (by its use or rental), personal use by the debtor or any other use approved by the bankruptcy court.

As several courts have emphasized in rejecting a foreclosure valuation for collateral that is to be retained by the debtor and *not* sold at foreclosure (*In re Trimble*, 50 F.3d at 532):

> If the first sentence of § 506(a) were interpreted to mean that the value must be fixed at the amount which the creditor would receive on foreclosure, then the last sentence of the statute which provides that the value should be determined in light of the purpose of the valuation and of the proposed disposition or use of the property, would be surplusage.

Accord, *e.g.*, *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 76 (the use of foreclosure value when no foreclosure is intended "renders the second sentence of § 506(a) virtually meaningless"); *In re Balbus*, 933 at 250-251. "[T]he only way to read the statute without effectively erasing the second sentence [is] to deduct sales costs only if there were an actual sale." *Lomas Mortgage USA* v. *Wiese*, 980 F.2d 1279, 1285 (9th Cir. 1992), vacated on other grounds, 508 U.S. 958 (1993). As the court explained in *In re Courtright*, 57 B.R. 495, 497 (Bankr. D. Ore. 1986) (emphasis added), the contrary interpretation of the statute adopted by the court of appeals in this case

> would mean that the value should always be fixed at the amount which the creditor would receive upon foreclosure regardless of the purpose of the valuation and of the proposed disposition or use of the property. The test would not depend upon whether the debtor intended to release the property or intended, instead to retain and use the property. *It is not appropriate for the court to ignore or give no effect to the language of the last sentence of the statute.*

Accord, *e.g.*, *In re Coker*, 973 F.2d 258, 260 (4th Cir. 1992) ("all provisions in a statute must be given effect").

A proposal under the plan to retain, rather than sell, the collateral is quite obviously a proposal about the "disposition or use" of that collateral. Congress expressly required that the "proposed disposition or use" be considered in valuing the secured claim. A rule of law that makes sale or retention irrelevant—and that mandates the same valuation in either event—would make the second sentence of Section 506(a) surplusage and is, for that reason, unacceptable.[3] See *Bailey* v. *United States*, 116 S.Ct. 501, 506-507 (1995); *United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 36

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[3] The court of appeals stated that its valuation standard does not establish a fixed rule for all cases because "what the creditor could realize at a foreclosure sale is only a *starting point* for the valuation" and the "bankruptcy court may make additions to or deductions from this amount depending upon 'equitable considerations arising from the facts of the case' " (Pet. App. 48a). The statute, however, requires that the valuation be made based upon the "proposed disposition or use" of the collateral, not based upon "equitable factors." Compare 11 U.S.C. 506(a) with 11 U.S.C. 552(b) (instructing bankruptcy court to consider the "equities of the case" in determining post-petition effect of security interest). Moreover, as the dissent noted in this case, if "equitable considerations" properly enter into the valuation of secured claims, they can be applied to valuations made from any "starting point" – whether that point is retail or foreclosure value (Pet. App. 74a). The use of foreclosure value for the valuation of collateral that is not to be sold at foreclosure simply ignores the statutory requirement that the "proposed disposition or use" of the collateral be considered in every valuation under Section 506(a).

(1992); *Reiter* v. *Sonotone Corp.* 442 U.S. 330, 339 (1979).

c. When property is to be retained by the debtor rather than sold at foreclosure, valuing the property at its replacement cost corresponds to the economic reality of its "proposed disposition or use" and "is the only method that gives full effect to the entire language of section 506(a)." *In re Trimble*, 50 F.3d at 532. When the replacement cost to the debtor is the retail price—because the debtor is a retail rather than a wholesale buyer—the "retail valuation" properly reflects the "economic benefit for the debtor" from its continued possession and "use of the collateral to generate an income stream" (*In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75).

A debtor who seeks "to continue use of [the] creditor's collateral" thereby "acknowledg[es] the value of the collateral to be greater than if liquidated." *In re Trimble*, 50 F.3d at 531. The "debtor should not be heard to argue that, in valuing the collateral, the court should disregard the very event that, according to the debtor's plan, *will* take place—namely, the debtor's use of the collateral to generate an income stream." *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75. When property is thus to be retained by the debtor, its value in the hands of the debtor is therefore "equal to [its] fair market value," or replacement cost, rather than merely its net foreclosure value. *Ibid.* Accord, *e.g.*, *In re Trimble*, 50 F.3d at 532 ("the retail value * * * without deduction for costs of repossession or sale"); *In re McClurkin*, 31 F.3d at 404-405. See also *In re Taffi*, 96 F.3d at 1192 ("the price which a willing seller under no compulsion to sell and a willing buyer under no compulsion to buy would agree upon").

d. As the court explained in *In re Taffi*, 96 F.3d at 1192-1193, "[t]here is nothing inequitable" in valuing collateral retained by the debtor at its fair market price for, by "allowing the [debtors] to retain [the collateral,] the [creditor] runs a risk" that ultimate recovery will be deferred or defeated. When a creditor is permitted to sell property at foreclosure, the net foreclosure proceeds are then promptly received. When, by contrast, the "proposed disposition" is for the debtor to retain the property, the creditor receives payment of its secured claim only in small portions over time. As the court stated in *In re Balbus*, 933 F.2d at 250, quoting *In re Crockett*, 3 B.R. 365, 367 (Bankr. N.D. Ill. 1980):

> [T]he debtors cannot eat with the hounds and run with the hares. Seeking retention of the property, they cannot insist on liquidation values to be paid to the creditor in installments.

Valuing the collateral retained by the debtor at its fair market or replacement cost does not effect any "'windfall' to the creditor, and certainly not one that will spur secured creditors to eschew their state law remedies and seek refuge in the comfortable confines of the bankruptcy courts." *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 76.[4] By contrast, the

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[4] This Court has established the general principle that a party should not receive "a windfall merely by reason of the happenstance of bankruptcy." *Butner* v. *United States*, 440 U.S. 48, 55 (1979), quoting *Lewis* v. *Manufacturers National Bank*, 364 U.S. 603, 609 (1961). A secured creditor does not enjoy a "windfall" by the proper valuation of collateral retained by the debtor. A "windfall" is a benefit received without risk or cost. The secured creditor in a cramdown has

decision of the court of appeals in this case would create a situation prone to abuse—if the debtor were permitted to retain the collateral and to "strip[] down the lien to liquidation value," the debtor could then "sell[] the collateral at fair market value, thus pocketing equity that would have been completely beyond reach save for the filing of the bankruptcy petition." *Ibid.*

2. a. The court of appeals failed to justify its departure from the statutory requirement that the "proposed disposition or use" of the collateral be considered in valuing the secured claim. The court reasoned that the "proposed disposition or use" of the collateral would remain relevant in determining the net foreclosure value by "delineating the market for the collateral by indicating a use which may be of interest to potential buyers at a foreclosure sale" (Pet. App. 25a). But the proposed *future* use of the property by the debtor is of no relevance in establishing the net proceeds from a hypothetical foreclosure sale that would be conducted *before* the property is put to that use. If, by hypothesis, the property were sold at foreclosure, the particular use thereafter made of that property by the hypothetical buyer might increase or decrease the *subsequent* value of the property. But that future use would not alter the value of the property on the date of the approval of the plan—which is the relevant date for valuation of the "secured claim" under Section 506(a). 4 *Collier on Bankruptcy* ¶ 506.02[6][j], at 506-31 (15th ed. rev. 1996).

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incurred both risks and costs from the deferral and resulting diminution of recovery upon its secured claim.

For the same reason, the court erred in stating that a "proposed disposition or use" of the property would remain relevant if that use were "particularly beneficial, or particularly detrimental, to [the] value" of the collateral (Pet. App. 25a, quoting James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L.J. 18, 37 (1987)). A *subsequent* use that benefits or depreciates the collateral has no bearing on the value of that collateral *before* that use is authorized by the bankruptcy plan. It therefore has no bearing on value when the "purpose of the valuation" (11 U.S.C. 506(a)) is to determine the value of collateral on the date that the plan is approved.[5]

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[5] When, by contrast, only a *temporary* use of the property by the debtor is intended before foreclosure is to be allowed, a detrimental use may decrease the foreclosure value of the collateral. Congress specified in Sections 361 and 363 of the Bankruptcy Code that the debtor must provide additional, "adequate protection" to the creditor's interest if temporary use of the collateral by the debtor would "result[] in a decrease in value" of the creditor's interest. 11 U.S.C. 361(1). See 11 U.S.C. 363(e). When the "purpose of the valuation" (11 U.S.C. 506(a)) is to determine a need for adequate protection, Congress thus specified in Section 361(1) that the effect of the temporary use on the value of the collateral must be considered.

The need for "adequate protection" arising from temporary use of the collateral by the debtor is one of the many contexts in which a valuation of the collateral is required under Section 506(a). See note 2, *supra*. The requirement in Section 506(a) that the "proposed disposition or use" of collateral be considered does not, as the court of appeals mistakenly suggested (Pet. App. 26a-27a), refer only to valuations for the purpose of determining "adequate protection" under Section 361. There was no reason for Congress to specify in the general valuation provisions of Section 506(a) that the

b. The court of appeals also erred in reasoning that deference to state law requires that the value of the "secured claim" under Section 506(a) be limited to the net foreclosure value of the property. The court stated that, outside of the bankruptcy context, state law would permit the secured creditor to sell the collateral and thereby obtain its net foreclosure value "and nothing more" (Pet. App. 14a). The court concluded that, in enacting the Bankruptcy Code, Congress would not have altered that nonbankruptcy, state-law right of secured creditors without saying so in the clearest of terms (*id.* at 9a-10a).

But Congress obviously *has*, in the clearest of terms, authorized substantial departures from state law in reshaping creditor rights under the Bankruptcy Code. Of particular relevance to this case, Congress has (i) enjoined the secured creditor from exercising its right to foreclose on the collateral during the pendency of the bankruptcy case (11 U.S.C. 362) and (ii) authorized the bankruptcy court to permit the debtor thereafter to retain and use the collateral (11 U.S.C. 1129(b)(2)(A)(ii), 1325(a)(5)(B)). It is precisely because federal law thus disrupted the state-law rights of creditors in bankruptcy cases that it was necessary for Congress, in Section 506(a) of the Bankruptcy Code, to require that the ultimate "disposition or use" of the collateral be given account in determining the value of the "secured claim."

"proposed disposition or use" of collateral be considered if all that Congress meant to require was that a "detrimental" use be considered when the temporary possession of the collateral by the debtor would "result[] in a decrease in the value" of the creditor's interest. 11 U.S.C. 361(1). The plain text of Section 361(1) had already made that requirement clear.

When a debtor is permitted by the Bankruptcy Code to retain and use the collateral, the state-law right of the secured creditor to obtain immediate foreclosure is displaced as a matter of federal law. Section 506(a) then reconstitutes the rights of the secured creditor, as a matter of federal law, based upon the "proposed disposition or use" of the collateral. For this reason, all of the courts of appeals (other than the court in this case) have agreed that prebankruptcy state-law rights do not govern the determination of post-bankruptcy creditor rights under Section 506(a). See, *e.g.*, *In re Taffi*, 96 F.3d at 1192; *In re Trimble*, 50 F.3d at 531; *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75; *In re McClurkin*, 31 F.3d at 404-405. As the dissent noted in this case (Pet. App. 69a), valuing the secured claim at the replacement cost of the property in the hands of the debtor

> would not "displace" a well-established area of state law, for the simple reason that there is no state law regarding the rights of secured creditors in reorganizations. In fact, the Constitution has prevented the states from passing such laws for the past 207 years.

It is federal law, not state law, that determines the rights of secured creditors in bankruptcy.

c. The court of appeals also erred in relying on legislative history to nullify the statutory text. Legislative history cannot annul the plain command of the statute that the "proposed disposition or use" of the collateral be considered in valuing the secured claim (11 U.S.C. 506(a)). Moreover, to the extent that such history is relevant, it confirms that the court of appeals erred in interpreting the statute to require a

net foreclosure valuation when property is retained by the debtor and foreclosure is *not* permitted.

The Senate Report confirms that any valuation of the secured claim must reflect the proposed disposition or use of the collateral: "While courts will have to determine value on a case-by-case basis, [Section 506(a)] makes it clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property." S. Rep. No. 989, 95th Cong., 2d Sess. 68 (1978). The House Report similarly rejects any rule that would impose a forced sale or liquidation value in all cases:

> "Value" does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977). Imposing a "forced sale or liquidation value" in *every* case—as the court of appeals would require—fails to honor both the statutory text and the evident legislative intent that the "proposed disposition or use" of the property be considered in valuing the secured claim.

The court of appeals sought to rely on passages from the House Report that suggest that a Chapter 13 debtor would, in narrowly defined situations, be able to retain certain types of property without paying "high replacement costs" (Pet. App. 42a, quoting H.R. Rep. No. 595, *supra*, at 127). The portion of the House Report on which the court relied, however, concerns a different statutory provision and a

different substantive issue than is involved in this case. Section 722 of the Bankruptcy Code established a "new and * * * broader" right of redemption for debtors than existed under preexisting state law. S. Rep. No. 989, *supra*, at 95. Under Section 722, a debtor may "redeem tangible personal property intended primarily for personal, family, or household use" when such property is not within the bankruptcy estate and is therefore subject to prompt foreclosure under state law. 11 U.S.C. 722. To avoid foreclosure and the attendant necessity (in the absence of a state-law right of redemption) of purchasing a similar item at a "high replacement cost" (H.R. Rep. No. 595, *supra*, at 127), the debtor is permitted by Section 722 to extinguish the lien by "redeeming" it in advance of foreclosure. The House Report explains, as an example, that, if the personal property to which the statute applies is "subject to a $1200 lien," "[t]his section permits [the debtor] to pay the holder of the lien $1200 and redeem the entire [property]." *Id.* at 381.

This right of redemption under Section 722 applies when the creditor would be permitted to receive an immediate payment of its lien through foreclosure. H.R. Rep. No. 595, *supra*, at 127. Section 722 does not apply to the different situation addressed in this case, when (i) property is to be retained and used by the debtor, (ii) foreclosure of the lien is not permitted, and (iii) prompt payment of the creditor will not occur. The history of Section 722 thus provides no guidance for the proper valuation of the secured claim in the markedly different context of this case.

Indeed, the House version of the bill—on which the House Report was based—provided no guidance whatever concerning the proper method for valuing a secured claim. See H.R. 8200, 95th Cong., 1st Sess.,

§ 506(a) (1977). The requirement of Section 506(a) that the "proposed disposition or use" of the collateral be considered in such valuations originated in the competing Senate version of the bill (S. 2266, 95th Cong., 1st Sess., § 506(a) (1977) (amended May 17, 1978)) and was adopted in conference in preference to the House bill. 124 Cong. Rec. 32,398 (1978) (Rep. Edwards); 124 Cong. Rec. 33,997 (1978) (Sen. DeConcini). The provisions of Section 506(a) that are at issue in this case were not reflected in the House Report on which the court of appeals relied.

d. Finally, the court of appeals erred in stating (Pet. App. 29a) that "Economic Analysis" supports nullification of the statutory command that the "proposed disposition or use" of the collateral be considered in valuing the secured claim. The court reasoned that foreclosure valuation of the collateral is preferable because it denies the secured creditor the benefit of retail sales expenses "in which the creditor does not have a security interest" (*id.* at 32a). The court stated that any valuation above net foreclosure value would improperly give the secured creditor a "windfall * * * in the form of a 'cram down premium'" (*id.* at 34a-37a).

It is, however, plainly the task of Congress, not the courts, to determine the ultimate fairness or wisdom of the statutory rules that allocate the limited funds and property of the debtor among competing claimants in bankruptcy cases. The possibility that a court might prefer a balance of interests that differs from the balance struck by Congress does not jusify a departure from the statutory text. "We are bound by the language of the statute as it is written, and even if the rule [a party] advocates might 'accor[d] with good policy,' we are not at liberty 'to rewrite [the] statute

because [we] might deem its effects susceptible of improvement.'" *Commissioner* v. *Lundy*, 116 S.Ct. 647, 656-657 (1996), quoting *Badaracco* v. *Commissioner*, 464 U.S. 386, 398 (1984).

Moreover, for the reasons discussed above, "[t]here is nothing inequitable" in valuing collateral retained by the debtor at its fair market price (*In re Taffi*, 96 F.3d at 1192). Indeed, if the debtor were permitted to *avoid* foreclosure by retaining the collateral *and* the secured claim were stripped down to its foreclosure value under Section 506(a), an evident potential for abuse would exist from the debtor's ability then to "pocket[] equity that would have been completely beyond reach save for the filing of the bankruptcy petition." *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 76. See pages 15-16 & note 4, *supra*.

3. a. Eight circuits have rejected the conclusion of the court of appeals in this case that, when the debtor is to retain the collateral, the secured claim is to be reduced to its net foreclosure valuation. Six of these circuits have agreed that, in this context, the value of the secured claim is the retail or replacement value of the collateral:

> When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral. Neither the foreclosure value nor the costs of repossession are to be considered because no foreclosure is intended. Instead, when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive

> for the debtor's continued possession. Hypothetical sales costs are not to be considered because no sale is intended.

In re Taffi, 96 F.3d at 1192. See also *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 74; *In re Trimble*, 50 F.3d at 532; *In re McClurkin*, 31 F.3d at 404; *In re Coker*, 973 F.2d at 260; *In re Balbus*, 933 F.2d at 250-251.

In two recent decisions, however, the Second and Seventh Circuits disagreed with all of the prior decisions on the valuation of collateral under Section 506(a). These courts concluded that, when the collateral is to be retained and used by the debtor under the plan, the value of that collateral (and therefore the amount of the "secured claim" under Section 506(a)) is an amount halfway between (i) the retail price that a willing buyer in the debtor's position would be required to pay to obtain such property and (ii) the wholesale price for such property (even though that price would be unavailable to a buyer in the debtor's position). *In re Valenti*, No. 95-5079, 1997 WL 31577 (2d Cir. Jan. 15, 1997); *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996).

In reaching this conclusion, the Seventh Circuit postulated a hypothetical bargaining process between a secured creditor with the power to foreclose and a debtor with the power to surrender the collateral and purchase a replacement. *In re Hoskins*, 102 F.3d at 315-316. In that situation, the court hypothesized, the outcome would be a bargain struck between foreclosure and replacement values because, at such a price, the creditor would be better off than if it had to foreclose and the debtor would be better off than if it had to replace the property. *Ibid.* Acknowledging

that "[t]here is no way to predict where in the bargaining range the bargain would be struck," the court adopted the midway point, or average of the two values, for ease of administration and predictability. *Id.* at 316. In *In re Valenti*, 1997 WL 31577 at *4-*6, the Second Circuit approved a similar "compromise" valuation of the collateral but held that the statute did not impose any specific valuation standard. Instead, the court reasoned that valuation is a factual issue and that a compromise valuation of property retained by the debtor is not an abuse of discretion. *Ibid.*

The "compromise" method of valuation approved by the Second Circuit in *Valenti* and mandated by the Seventh Circuit in *Hoskins* lacks support in either the logic or the text of the statute. The text of the statute directs that a "value" be determined—it does not direct that a compromise be struck. The possibility that a court might conclude that this statute could plausibly be interpreted in one of two ways would not support a ruling based solely upon a compromise between the alternatives. Such a "compromise" would not be a valid exercise of the court's duty to determine the meaning of the statute and to enforce it as written. Section 506(a) refers to a "value"; it does not refer to an average between two alternative valuations.

The authority granted to the debtor to retain and use the collateral is not based on any implicit or hypothetical bargaining with the creditor—instead, it is dependent solely upon compliance with the provisions of the Bankruptcy Code that require that the "value" of the secured claim be paid under the plan if the debtor is permitted to retain and use the collateral. See 11 U.S.C. 1325(a)(5); note 1, *supra*. Because it is the debtor who elects under the Bankruptcy Code

to retain the property or allow it to be sold, it is illogical for the debtor to contend that the "value" of the collateral retained is less than its replacement value. *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75. By proposing to retain the collateral the debtor has "acknowledged the value of the collateral to be greater than if liquidated." *In re Trimble*, 50 F.3d at 531.

Commercial property retained by the debtor has a readily discernible "value." That value is the cost that the debtor would incur in obtaining similar property for the same income-producing use—the price that a willing buyer in the debtor's position would pay a willing seller for the right to obtain and use such property. The debtor in this case would be required to purchase such property at retail and would not be able to purchase such property at wholesale. The "value" of the property in the debtor's hands is thus necessarily its retail price—for that is the price the debtor would be required to pay for the right to use such property in its business. The wholesale price of property is not relevant in determining the "value" of such property in the hands of a retail buyer.

b. The use of retail or replacement value represents a rational allocation of bankruptcy risks when a debtor is permitted to retain property under a plan. Studies have shown that the majority of Chapter 13 plans fail. See *In re Rash*, 90 F.3d 1036, 1064 n.6 (5th Cir. 1996) (citing studies). Despite this substantial risk of default, the filing of a petition for relief in bankruptcy and the confirmation of a plan deprives a secured creditor of an important element of the protection that it bargained for: the state-law right to foreclose on its collateral. At the same time, the plan grants the debtor the benefits of using the collateral.

If the collateral is the debtor's personal residence, as it was in *Taffi*, 96 F.3d at 1191, these benefits will include housing and avoidance of the costs of moving; if the collateral is a wage-earner's personal car, as it was in *Hoskins*, 102 F.3d at 311, the benefits will include the use of the car in going to work; if the collateral is an income-producing asset, like the tractor-trailer truck here, the benefits include the income produced with the aid of the asset.

Whatever the nature of the collateral, the court may assume that it has value to the debtor, who has proposed to retain it under the plan. The replacement cost of the asset is the "value" that the debtor *actually*—not hypothetically—receives under the plan. *In re Rash*, 90 F.3d at 1062 n.1. By contrast, the creditor under such a plan will *actually* (not hypothetically) suffer a substantially increased risk of loss from the deferral in its recovery of the secured debt. *In re Taffi*, 96 F.3d at 1192-1193. The replacement cost of the collateral establishes its "value" when it is to be retained by the debtor, for it reflects "the economic benefit for the debtor" from its continued possession and "use of the collateral to generate an income stream" (*In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d at 75). It is thus accurate and proper—and neither unfair nor inequitable—to recognize that the "value" of the property being used for this purpose is the cost that the debtor would be required to pay to obtain an identical asset for the same "proposed * * * use" (11 U.S.C. 506(a)). See *In re Taffi*, 96 F.3d at 1192.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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